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COORDINATED ISSUE
FOREIGN TAX CREDIT
RETROACTIVE CLAIMS TO ELECT THE FMV METHOD OF INTEREST EXPENSE APPORTIONMENT
UIL 861.09-10

ISSUE

Whether the doctrine of election precludes a taxpayer from amending past years' returns to elect retroactively to value its assets according to their fair market value for purposes of apportioning interest expense under Treasury Regulation section 1.861-9T(g), when the taxpayer originally elected to value the assets under the tax book value method for those years.

LAW AND ANALYSIS

Background

Section 901 allows a credit for foreign income, war profits, and excess profits taxes paid or deemed paid by qualifying taxpayers. Section 904(a) limits a taxpayer's foreign tax credit to an amount equal to the precredit U.S. tax on the taxpayer's foreign source taxable income. The section 904 limitation is calculated by multiplying a taxpayer's U.S. tax liability (before the foreign tax credit) by the following fraction:

$$\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}}$$

Sections 861(b), 862(b), and 863(a) provide that taxable income attributable to gross income from domestic or foreign sources shall be determined by deducting the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, and other deductions that cannot be definitely allocated to some item or class of gross income. Treasury Regulation sections 1.861-8 through 1.861-17 provide specific guidance regarding the allocation and apportionment of deductions. Generally stated, deductions are allocated to classes of gross income and, as required by operative sections of the Code, apportioned between statutory and residual groupings of gross income.

The allocation and apportionment regulations emphasize the factual relationship between deductions and gross income. A deduction is considered to be definitely related to a class of gross income, and therefore allocable to such class, if the deduction is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. If a deduction is not definitely related to a class of gross income constituting less than all gross income, it is generally treated as allocable to all gross income. Interest expense is deemed allocable to all classes of gross income.

The Asset Method of Apportionment

Section 864(e)(2) provides that all allocations and apportionments of interest expense must be made on the basis of assets rather than gross income. The asset method of apportioning interest is based on the approach that, in general, money is fungible and that interest expense incurred in borrowing money is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. Under the asset method, a taxpayer apportions interest expense between statutory and residual groupings of gross income in proportion to the average total values of the assets within each such grouping for the taxable year. Treas. Reg. § 1.861-9T(g)(1)(i). For example, for a taxpayer claiming the foreign tax credit, gross income from foreign sources is a statutory grouping because taxable income from foreign sources is the foundation of the section 904 limitation.

Treasury Regulation section 1.861-9T(g)(1)(ii) allows a taxpayer to elect to make this allocation on the basis of either the tax book value or the fair market value of its assets. Although the election is generally indicated by marking a box on Schedule H of Form 1118 attached to the taxpayer's federal income tax return, a taxpayer can also communicate the election by allocating its interest expense pursuant to a particular valuation method. Once a taxpayer elects to use the fair market value method, the regulations require the taxpayer and all related persons to continue to use that method unless the Commissioner expressly authorizes a change in method. Treas. Reg. § 1.861-8T(c)(2).

The Doctrine of Election

The doctrine of election generally binds a person to their initial choice, when the person had an equal right to choose one or more alternatives or inconsistent rights. J. Mertens, *Law of Federal Income Taxation* § 60.27 (1989). "[A] viable, healthy doctrine applicable to elections made under the tax laws," the doctrine of election has enjoyed widespread application. Grynberg v. Commissioner, 83 T.C. 255, 261 (1984).

The doctrine of election as it applies to federal tax law consists of the following two elements: (1) There must be a free choice between two or more alternatives; and (2) there must be an overt act by the taxpayer communicating the choice to the Commissioner, i.e., a manifestation of choice. See Grynberg, 83 T.C. at 261. See also Bayley v. Commissioner, 35 T.C. 288, 298 (1960), acq., 1961-2 C.B. 4; Burke & Herbert Bank & Trust Co. v. Commissioner, 10 T.C. 1007, 1009 (1948). Pursuant to the doctrine of election, a taxpayer that makes a conscious election under the tax laws may not, without the consent of the Commissioner, revoke or amend its election merely because events do not unfold as planned. See, e.g., J.E. Riley Inv. Co. v. Commissioner, 311 U.S. 55 (1940); Pacific Nat'l Co. v. Welch, 304 U.S. 191 (1938).

Pacific Nat'l Co. v. Welch, 304 U.S. 191 (1938), is "often regarded as the fundamental authority for the development" of the doctrine of election. Estate of Stamos v. Commissioner, 55 T.C. 468, 473 (1970). In Pacific National, the taxpayer had the option of treating certain income

under either the deferred payment or installment method. The taxpayer reported the income using one method and later sought a refund based on a computation under the other method. Among the reasons articulated by the Supreme Court for its refusal to allow the taxpayer's change from one method to the other is that such changes would require recomputation and readjustment of tax liability for subsequent years. Id. at 194. Pacific National established the general rule that a taxpayer that elects a proper method on a return may not later revoke or change that election and substitute another method.

The doctrine of election has been applied in a widespread manner under a variety of Code provisions. In Grynberg, the Tax Court applied the doctrine of election to prohibit a taxpayer from changing its method of calculating its charitable contribution deduction to another permissible method. Id. See also, e.g., Rose v. Grant, 39 F.2d 340 (5th Cir. 1930) (husband and wife prohibited from filing separate returns after making valid election to file joint returns); Burke & Herbert Bank & Trust Co., 10 T.C. 1007 (1948) (taxpayer was prohibited from changing an election upon realization that such election was disadvantageous.)

The courts have articulated several rationales supporting the general principle that taxpayers are bound by their elections. These rationales include: (1) Preventing administrative burdens and inconvenience in administering the tax laws, particularly when the new method chosen requires a recalculation of tax liability for several taxable years or for other taxpayers; (2) protecting against the loss of revenue by preventing taxpayers from using the benefit of hindsight to choose the most advantageous method of reporting; and (3) promoting consistent accounting practice (i.e., foreclosing adjustments based on hindsight), thereby securing uniformity in the collection of revenue. J.E. Riley Inv. Co. v. Commissioner, 311 U.S. at 59; Pacific Nat'l Co. v. Welch, 304 U.S. at 194; Mamula v. Commissioner, 346 F.2d 1016, 1018-19 (9th Cir. 1965); Barber v. Commissioner, 64 T.C. 314, 319-320 (1975); Thorrez v. Commissioner, 31 T.C. 655, 668 (1958), aff'd. per curiam 272 F.2d 945 (6th Cir. 1959); Pacific Vegetable Oil Corp. v. Commissioner, 26 T.C. 1, 16 (1956), revd. on another issue 251 F.2d 682 (9th Cir. 1957); Estate of Curtis v. Commissioner, 36 B.T.A. 899, 906-07 (1937). While these points support application of the doctrine of election, they are properly construed as underlying explanations of the doctrine, and not required elements for its application. Accordingly, the absence of one or more of these considerations in a particular case does not render the doctrine of election inapplicable.

The courts have recognized a limited number of exceptions to the doctrine of election, under which taxpayers may be permitted to change affirmative elections made on their federal tax returns: (1) The amended return was filed prior to the date prescribed for filing the original return; (2) the taxpayer's treatment of the contested item in the amended return was not inconsistent with his treatment of that item in his original return; or (3) the taxpayer's treatment of the item in the original return was improper and the taxpayer elected one of several allowable alternatives in the amended return. See Grynberg, 83 T.C. at 262; Goldstone v. Commissioner, 65 T.C. 113, 116 (1975). It should be noted that, outside of these limited circumstances (as well as analogous circumstances not involving elections), amended returns are regarded as "creature[s] of administrative origin and grace," and acceptance of amended returns is solely within the discretion of the Commissioner. Badaracco v. Commissioner, 464 U.S. 386, 393

(1984). See also Cloutier v. United States, 709 F.2d 480, 484 (7th Cir. 1983); Koch v. Alexander, 561 F.2d 1115, 1117 (4th Cir. 1977); Miskovsky v. United States, 414 F.2d 954, 955 (3d Cir. 1969). Cf. Woodbury v. Commissioner, 900 F.2d 1457, 1461 (10th Cir. 1990); Keeler v. Commissioner, 180 F.2d 707, 710 (10th Cir. 1950).

Some courts have discussed further exceptions to the doctrine of election for certain taxpayer "mistakes." See, e.g., Grynberg, 83 T.C. at 261; Shull v. Commissioner, 30 T.C. 821, 828 (1958). While the scope and application of these exceptions in the context of the doctrine of election is far from clear, it is apparent that taxpayers cannot retroactively revoke an election on the sole basis that they later realize, through hindsight, that an elected choice failed to maximize their tax benefits. Such a "mistake" exception would virtually swallow the doctrine of election and thereby contradict the well-established principle that an exception to a rule cannot be construed so broadly as to render the rule meaningless. See, e.g., Camps Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564, 594 (1997); Digital Equipment Corp. v. Desktop Direct, 511 U.S. 863, 868 (1994); Guidry v. Sheet Metal Workers Nat'l Pension Fund, 493 U.S. 365, 377 (1990). Thus, a taxpayer's failure to ascertain the fair market value of its assets for purposes of electing the fair market value method on its original return cannot be considered a "mistake" that entitles it to revoke its original tax book value method election. As the Tax Court observed, "Oversight, poor judgment, ignorance of the law, misunderstanding of the law, unawareness of the tax consequences for making the election, miscalculation, and unexpected subsequent events have all been held insufficient to mitigate the binding effect of elections made under a variety of provisions of the Code." Grynberg, 83 T.C. at 262 (quoting Estate of Stamos, 55 T.C. 468, 474 (1970)).

ANALYSIS

A retroactive election to change from the tax book value method to the fair market value method of apportioning interest expense may considerably impact a taxpayer's section 904 foreign tax credit limitation calculation, allowing a taxpayer to claim more foreign tax credits. This may be true particularly when the taxpayer is in an excess foreign tax credit position as to U.S. income taxes and its U.S. assets have appreciated significantly in comparison to its foreign assets.

Until recently, most taxpayers elected to value assets based on the tax book value method, in part because of the difficulty and expense inherent in determining the fair market value of assets. However, with the development of computer software, fair market value studies have become more accessible to taxpayers, resulting in more taxpayers making the fair market value method election on current returns. In addition to fair market value elections made on current year returns, some taxpayers have filed informal claims to elect retroactively the fair market value method. Often, taxpayers' informal claims are based on extrapolated fair market values, derived from the study of fair market values of assets for taxpayers' prospective elections. Typically these claims, which require a team of international examiners, engineers, economists, computer audit specialists, and outside experts to audit, are filed late in the audit cycle, resulting in an enormous administrative burden on the Internal Revenue Service.

Taxpayers' prospective elections of the fair market value method on an original return are

permissible under the regulations. However, taxpayers' retroactive fair market value elections are generally prohibited by the doctrine of election because the two elements required for its application are present: Taxpayers have a free choice between utilizing the tax book value and fair market value methods, and taxpayers also affirmatively manifest this choice on their returns.

The doctrine of election will not apply if taxpayers amend their returns prior to the due date of such original return. However, a request to utilize the fair market value method is inconsistent with the prior use of the tax book value method, which is a permissible method for apportioning interest expense. Thus, the "timely filing" exception to the doctrine of election could apply to specific fact patterns; the latter two exceptions should not.

CONCLUSION

In conclusion, unless a taxpayer falls within the timely filing exception, the doctrine of election applies to prevent a taxpayer from amending past years' returns to retroactively elect the fair market value method of apportionment. This issue should be coordinated to ensure that taxpayer retroactive fair market value claims are treated uniformly and consistently by Internal Revenue Service personnel.